Statement of
Senator Susan M. Collins

'Where Were the Watchdogs? Systemic Risk and the Breakdown of Financial Governance'

Committee on Homeland Security and Governmental Affairs
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Today the Committee examines the need to establish a systemic-risk monitor that might have helped prevent the financial crisis that our nation now confronts.

America's financial crisis has spread from Wall Street to Main Street, affecting the livelihoods of people all across the country. The American people deserve the protection of a new regulatory system that modernizes regulatory agencies, sets safety and soundness requirements for financial institutions to prevent excessive risk-taking, and improves oversight, accountability, and transparency.

Our financial regulators should have had the ability to see the current collapse coming and to act quickly to prevent or mitigate its impacts. Unfortunately, oversight gaps in our existing system, risky financial instruments with little or no regulatory oversight, and a lack of attention to systemic risk undermined our financial markets.

When the entire financial sector gambled on the rise of the housing market, no single regulator could see that everyone – from mortgage brokers to credit default swap traders – was betting on a bubble that was about to burst. Instead, each agency viewed its regulated market through a narrow tunnel, missing the total risk that permeated our financial markets.

When the housing market collapsed, the impact set off a wave of consequences. Borrowers could no longer refinance their mortgages, credit markets were frozen, consumer demand plummeted, businesses were unable to make payments or meet payrolls, and workers were laid off, making it difficult for even more families to pay their mortgages.

In Maine, the unemployment rate reached a 16-year high of seven percent at the end of 2008. There were also more than 2,800 foreclosures in Maine, not that many compared to other states, but nearly a 900 percent increase from the previous year.

This financial crisis has harmed virtually every American family. Taxpayers have financed bailout after bailout of huge financial institutions at the cost of trillions of dollars.

These drastic and expensive rescues might not have occurred had there been a regulator evaluating risk to the financial system as a whole. Such a regulator could have recognized the house of cards being constructed in our financial markets. While there are many regulators within the financial system, not one of them had the ability to evaluate risk across the entire financial system. For example, the Federal Reserve could clearly see the large number of securitized mortgages of banks within its jurisdiction, but had no visibility into the full extent of securitization at non-federally regulated banks or financial institutions regulated by the SEC.

What was needed then, and is needed now, is a systemic-risk regulator. The GAO and other government and industry officials, as well as academic experts, have called for the creation of such a monitor.

The creation of a systemic-risk monitor raises many new questions, however, about its structure and

authority. Should an existing regulator like the Federal Reserve be charged with monitoring systemic risk, or should a new entity be tasked with the responsibility? For example, should a council composed of the heads of our nation's financial regulatory agencies be assigned this duty?

We must consider what should occur when systemic risk is detected in the future. Should a systemic-risk entity be empowered to issue regulations, to review and approve new financial instruments, and to fill in regulatory "black holes" that result from overlapping or narrow agency jurisdictions? Or should the systemic-risk monitor be required to work through existing regulators?

In designing a better regulatory framework, we must take care not to create a moral hazard by making failure

impossible, to stifle useful new products, or to prevent beneficial risk sharing. The challenge is to ease the turmoil caused by failing-but-important institutions without setting off a cascade of trouble for otherwise healthy entities. In other words, we need a better system to prevent the development of catastrophic concentrations of risk at firms like Bear Stearns and AIG, and better systems to mitigate the collateral damage if they do fail.

Our goals must combine several vital objectives: stability for the financial system, safety and soundness regulation for institutions, protections for investors and consumers, transparency and accountability for transactions, and increased financial literacy for the public. Significant regulatory reforms are required to restore public confidence and to ensure that lack of regulation does not allow such a crisis in the future.

Hearings like this will help lay the groundwork for this new, more effective approach to financial regulation.

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